

September 25, 2003

Ms. Luly Massaro, Clerk  
Public Utilities Commission  
89 Jefferson Boulevard  
Warwick, RI 02888

Re: Docket 2930

Dear Ms. Massaro:

Enclosed for filing are an original and ten copies of the testimony of David Effron on behalf of the Division of Public Utilities and Carriers in Docket 2930 regarding the First Savings Proof filing of Narragansett Electric Company.

Sincerely,

Stephen Scialabba  
Chief Accountant

cc: service list

**THE NARRAGANSETT ELECTRIC COMPANY**

**EARNED SAVINGS PROOF**

**RIPUC DOCKET NO. 2930**

**BEFORE THE  
RHODE ISLAND PUBLIC UTILITIES COMMISSION**

**TESTIMONY AND EXHIBITS  
OF DAVID J. EFFRON**

**ON BEHALF OF THE**

**DIVISION OF  
PUBLIC UTILITIES AND CARRIERS**

**SEPTEMBER 25, 2003**

RIPUC DOCKET NO. 2930  
EARNED SAVINGS PROOF  
DIRECT TESTIMONY  
OF DAVID J. EFFRON  
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1    **I.        STATEMENT OF QUALIFICATIONS**

2    Q.        Please state your name and business address.

3    A.        My name is David J. Effron. My business address is 386 Main Street, Ridgefield,  
4              Connecticut.

5

6    Q.        What is your present occupation?

7    A.        I am a consultant specializing in utility regulation.

8

9    Q.        Please summarize your professional experience.

10   A.        My professional career includes over twenty years as a regulatory consultant, two years  
11              as a supervisor of capital investment analysis and controls at Gulf & Western Industries  
12              and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified  
13              Public Accountant and I have served as an instructor in the business program at  
14              Western Connecticut State College.

15

16   Q.        What experience do you have in the area of utility rate setting proceedings?

17   A.        I have analyzed numerous electric, telephone, gas and water rate filings in different  
18              jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys  
19              in rate case preparation, and provided assistance during settlement negotiations with  
20              various utility companies.

21              I have testified in over two hundred cases before regulatory commissions in  
22              Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas,

1 Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New York, North Dakota,  
2 Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

3

4 Q. Please describe your other work experience.

5 A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was  
6 responsible for reports and analyses concerning capital spending programs, including  
7 project analysis, formulation of capital budgets, establishment of accounting  
8 procedures, monitoring capital spending and administration of the leasing program. At  
9 Touche Ross & Co., I was an associate consultant in management services for one year  
10 and a staff auditor for one year.

11

12 Q. Have you earned any distinctions as a Certified Public Accountant?

13 A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest  
14 scores in the May 1974 certified public accounting examination in New York State.

15

16 Q. Please describe your educational background.

17 A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College  
18 and a Masters of Business Administration Degree from Columbia University

19

20 **II. PURPOSE AND SUMMARY OF TESTIMONY**

21 Q. On whose behalf are you testifying?

22 A. I am testifying on behalf of the Rhode Island Division of Public Utilities and Carriers  
23 ("the Division").

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Q. What is the purpose of your testimony?

A. In compliance with the Third Amended Stipulation and Settlement in Docket 2930 (“Settlement”), the Narragansett Electric Company (“Narragansett” or “the Company”) on June 27, 2003 filed its proof of savings achieved subsequent to the merger of the Blackstone Valley Electric Company and the Newport Electric Company into Narragansett in early 2000. The original filing on June 27 was subsequently revised in supplemental testimony on September 5. On September 22, the Company filed a second revision in the form of responses to the Division’s Second Set of Data Requests. The purpose of my testimony is to present the results of the Division’s review of the proof of savings filed by Narragansett.

**III. PROOF OF SAVINGS**

Q. What is the import of the proof of savings filed by Narragansett?

A. Section 8(A) of the Settlement required Narragansett to file an initial measurement of savings actually achieved since 2000 based on a cost of service (“COS”) for either 2001 or 2002, at the Company’s option. The achieved savings is calculated as the difference between the measurement year COS and a benchmark defined as the 2000 rate year COS of \$210,000,000 escalated for inflation and system growth. The Company would then be able to retain one-half of the calculated savings by including that amount in its cost of service subsequent to the end of the rate freeze on December 31, 2004.

1 Q. What amount of achieved savings did Narragansett calculate?

2 A. Narragansett chose 2002 as the measurement year. Based on the actual intrastate cost  
3 of service in 2002 and the 2000 rate year cost of service of \$210,000,000 escalated  
4 for inflation and system growth, the Company calculated gross savings of  
5 \$16,991,000 in its filing of September 22. Pursuant to the terms of the Settlement,  
6 Narragansett will be able to include one-half of this amount, or \$8,496,000 in its cost  
7 of service commencing January 1, 2005.

8

9 Q. Did you review the Company's calculation of achieved savings?

10 A. Yes. Section 8(A)(3) of the Settlement specifies that for the purpose of comparing  
11 the measurement year cost of service to the stipulated benchmark, the 2000 rate year  
12 cost of service of \$210,000,000 will be escalated by 50% of the change in the Gross  
13 Domestic Product Implicit Price Deflator ("GDPIPD") from 2000 through the  
14 measurement year, plus the escalated Benchmark COS times 30% of the percentage  
15 growth in the weather normalized measurement year KWH sales from the year 2000  
16 sales of 7,098,202,000 KWH. I verified the GDPIPD factors used by the Company  
17 and analyzed the calculation of the weather normalized measurement year KWH  
18 sales. I found no exceptions to the Company's Adjusted Benchmark Cost of Service  
19 of \$216,344,000 based on a 2002 measurement year.

20 Section 8(A)(1) of the Settlement specifies that for the purpose of the COS  
21 filing, actual measurement year results will be adjusted to reflect established  
22 Commission ratemaking principles and to incorporate any other normalizing  
23 adjustments as may be appropriate. I traced the components of the COS filing to the

1 Company's financial statements and verified that the measurement year COS  
2 reflected actual results. I then reviewed the allocation of the per books results of  
3 operations to the intrastate cost of service. Finally, I analyzed the normalizing  
4 adjustments incorporated by the Company into its determination of the measurement  
5 year COS to confirm that the adjustments reflected Commission ratemaking  
6 principles, as I understand them, and were consistent with the cost of service  
7 presentation that was used as a basis to develop the 2000 rate year benchmark COS  
8 of \$210,000,000.

9

10 Q. Did you note any exceptions to the Company's calculation of the measurement year  
11 COS?

12 A. During the course of the Division's review, several questions were raised concerning  
13 the calculation of the measurement year COS. Those questions were subsequently  
14 addressed and resolved in the Company's revised filings. Based on my examination,  
15 the measurement year COS of \$199,353,000 in the September 22 filing properly  
16 reflects established Commission ratemaking principles and appropriate normalizing  
17 adjustments.

18

19 Q. Does the Settlement itself contain effective protections against understatement of the  
20 measurement year COS, which would in turn lead to an overstatement of the  
21 achieved savings retained by the Company?

22 A. Yes. Section 11(A) of the Settlement requires a 50/50 sharing with customers of  
23 earnings in excess of a return on common equity ("ROE") of 12.00%, up to an earned



1 ROE of 13.00%, during the rate freeze period, 2000 - 2004. Any earnings in excess  
2 of a return on common equity of 13.00% in that period will be credited 75% to  
3 customers. In 2002, the earned return was well in excess of 13.00%. As the same  
4 principles are applied in the calculation of the earned ROE as in the determination of  
5 the measurement year COS, any understatement of the 2002 COS leading to an  
6 overstatement of achieved savings would also necessarily increase the earned ROE  
7 and thus increase the amount of the refund due customers. Thus, any understatement  
8 of the measurement year COS for the purpose of increasing the shared savings would  
9 have an offsetting cost to the Company.

10

11 Q. What are the implications of the \$8.5 million share of proven savings that the  
12 Company can include in its cost of service?

13 A. Commencing January 1, 2005, the Company will include this amount as an expense  
14 in the earnings reports that it files for the purpose of determining the earned ROE and  
15 the sharing of any excess earnings, pursuant to the formula for sharing excess  
16 earnings after the expiration of the rate freeze.<sup>1</sup> Further, in any COS rate case to  
17 change rates for usage on and after January 1, 2005, the Company can include this  
18 shared savings as an expense in its COS.

19

20 Q. If Narragansett files a COS rate case to increase rates for usage on and after January  
21 1, 2005, is it likely that the \$8.5 million of shared savings would ultimately be  
22 included in the determination of the Company's revenue requirements?

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<sup>1</sup> Effective 1/1/05, sharing begins at the authorized rate of return, currently 10.5%, rather than 150 basis points over the authorized return, in effect during the rate freeze period.

1 A. No. The Company will be able to propose that the \$8.5 million of shared savings be  
2 included in the COS. However, the savings calculated based on the 2002  
3 measurement year are subject to a “Second Savings Verification” (Settlement,  
4 Section 8(B)), which would employ the same method as this first proof of savings.  
5 Subsequent to that second savings proof, the shared savings will be either \$8.5  
6 million or the amount calculated in the second proof, whichever is less. The second  
7 savings proof will take place in the first COS rate case filed by the Company that  
8 reflects a historic test year not earlier than 2004<sup>2</sup>. If this has not occurred by April  
9 30, 2007, then Narragansett must make a filing by that date solely for purpose of  
10 verifying savings. However, if the Company files a COS rate case in 2004 to change  
11 rates for usage on and after January 1, 2005 and such filing would not otherwise  
12 trigger the “Second Savings Verification”, then the Commission has the authority to  
13 order that the “Second Savings Verification” take place in that proceeding.

14 If Narragansett were to file a COS rate case in 2004, that would likely imply  
15 that the COS had increased significantly since the 2002 measurement year. As the  
16 COS is the basis for calculating merger savings, such an increase in the COS would  
17 be an indication that merger savings had either sharply diminished since the first  
18 proof or had disappeared entirely. In such circumstances, one or more of the parties  
19 to the proceeding would probably propose to trigger the “Second Savings  
20 Verification.” I believe that it would be difficult for the Company to simultaneously  
21 establish that it was still achieving the merger savings as established in this first proof  
22 of savings and was also in need of a rate increase.

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<sup>2</sup> The Settlement specifies that the second savings proof will reflect a “historic test year that is no less than two years after the test year used for the first savings proof” (Section 8(B)).

1

2 Q. Would you like to call attention to changes in the level of any particular expenses that  
3 have affected the calculation of the achieved savings in this first proof?

4 A. Yes. Narragansett has calculated the achieved savings according to the formula  
5 specified in the Settlement, which requires a comparison of the cost of service in the  
6 measurement year to the adjusted benchmark cost of service based on a 2000 rate  
7 year. Changes in two expenses in particular from the 2000 rate year benchmark COS  
8 to the 2002 measurement year COS affected the calculation of shared savings. Those  
9 two expenses are pensions and municipal taxes.<sup>3</sup>

10 The pension expense included in the 2000 rate year was \$(133,000)<sup>4</sup>.  
11 Escalated to 2002 for inflation and system growth, the pension expense included in  
12 the adjusted benchmark cost of service is \$(137,000). The actual pension expense in  
13 2002 was \$(7,134,000) for a saving of \$6,997,000 against the benchmark (Schedule  
14 DJE-1).

15 The municipal tax expense included in 2000 rate year was \$20,653,000.  
16 Escalated to 2002 for inflation and system growth, the municipal tax expense  
17 included in the adjusted benchmark cost of service is \$21,276,000. The actual  
18 municipal tax expense in 2002 was \$15,964,000, which is \$5,312,000 less than the  
19 expense included in the adjusted benchmark cost of service. The reduction in the

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<sup>3</sup> The 2000 rate year COS of \$210 million was a stipulated amount. The cited amounts for the pensions and municipal taxes reflect the expenses included by the Company in that rate year COS, as those amounts were not at issue.

<sup>4</sup> The pension expense booked by the Company is based on Statement of Financial Accounting Standards 87. Pursuant to this accounting standard, if the pension plans are in an over-funded position, the periodic pension cost for a given year can actually be negative, resulting in the recording of pension income. The pension income, in effect, recognizes that the cumulative contributions to the pension plans in prior years and the returns earned by the funds have lead to a pre-payment of pension costs not previously recognized.

1       municipal tax expense was partially used to increase the accrual to the Environmental  
2       Response Fund by \$2,200,000 pursuant to a stipulation approved by the Commission  
3       in its Report and Order of January 29, 2003. Thus, the net measurement year savings  
4       against the benchmark as a result of the reduction to municipal taxes and the partially  
5       offsetting increase to the Environmental Response Fund accrual is \$3,112,000  
6       (Schedule DJE-1).

7               Together the reduction to pension expense and the net reduction to municipal  
8       tax expense accounted for \$10.1 million of the calculated savings (Schedule DJE-1),  
9       which is over half of the difference between the measurement year COS and the  
10      adjusted benchmark COS. The reductions to pension expense and municipal tax  
11      expense may prove to be temporary, as these expenses have fluctuated in recent years  
12      and the factors causing the lower level of these expenses in 2002 may not be  
13      permanent. If the decreases in pension expense and municipal tax expense from  
14      2000 to 2002 should reverse and those expenses begin to return to their levels in  
15      earlier years, I believe that it will be quite a challenge to sustain the savings  
16      quantified in this first proof.

17

18    Q.     Does this conclude your testimony?

19    A.     Yes.

20

THE NARRAGANSETT ELECTRIC COMPANY  
CHANGES IN EXPENSES  
BENCHMARK YEAR TO MEASUREMENT YEAR  
(\$000)

		<u>Pension Expense</u>	<u>Municipal Taxes</u>	<u>Total</u>
Actual Benchmark Year	(1)	\$ (133)	\$ 20,653	\$ 20,520
Escalation to Measurement Year	(2)	<u>1.0302</u>	<u>1.0302</u>	<u>1.0302</u>
Escalated Benchmark Expense		(137)	21,276	21,139
Actual 2002 Expense	(3)	<u>(7,134)</u>	<u>15,964</u>	<u>8,830</u>
Actual Expense vs. Benchmark		(6,997)	(5,312)	(12,309)
Offset for Increase to ERF Accrual	(4)	<u>-</u>	<u>2,200</u>	<u>2,200</u>
Net Expense Reduction		<u><u>\$ (6,997)</u></u>	<u><u>\$ (3,112)</u></u>	<u><u>\$ (10,109)</u></u>

## Sources:

- (1) Docket 2930, Rebuttal Filing 12/7/99
- (2) Exhibit MDL-1  $1.0118 * 1.0056 * (1 + 0.0416 * 0.3)$
- (3) Company Documents, Exhibit MDL-3, Page 9
- (4) Report and Order, January 29, 2003